



## BP EXPLORATION

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Mr. David S. Guzy  
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**RE: Supplementary Proposed Rule  
Establishing Oil Value for Royalty Due on Federal Leases  
63 Federal Register 6113, February 6, 1998**

Ladies and Gentlemen:

BP Exploration & Oil Inc., on behalf of itself and BP Exploration (Alaska) Inc. and BP America Inc. (collectively "BP"), appreciates the opportunity to submit comments to the Minerals Management Service's ("MMS") February 6, 1998, notice ("Notice") supplementing its proposed rulemaking that would amend federal regulations governing the valuation for royalty purposes of crude oil produced from federal leases.

BP has previously provided comments in response to the MMS' initial proposed rulemaking of January 24, 1997 (62 FR 3742), the MMS' supplementary proposed rulemaking of July 3, 1997 (62 FR 36030) and the MMS' request for comments on various suggested alternatives of September 22, 1997 (62 FR 49460). BP's comments appearing below are in response to the Notice and supplement those that we have previously provided to the MMS.

BP supports many of the changes the MMS has made in the Notice. In particular, we support the following:

- The change in 206.102 that would value oil ultimately sold or exchanged at arm's-length based on the gross proceeds accruing to the seller. Use of

the gross proceeds is the most accurate method of assessing the value of crude oil, and it should be used for all arm's-length sales and exchanges.

- The change in 206.103 that would match the lease production month with the applicable spot price delivery month. This change more adequately reflects the value of oil sold into the spot market from federal leases in the lower 48 states.
- The change in 206.103(c) from valuation based on the NYMEX futures settlement price to a spot price for oil at the market center nearest the lease and for crude oil most similar in quality to your oil. This change bases valuation on a crude more similar in quality and at a location closer to the lease, and eliminates an adjustment step in the valuation process which may be prone to error.
- The addition in 206.112(e) of a separate adjustment to reflect differences in crude oil quality according to applicable pipeline quality bank data. This addition is necessary to reasonably value federal oil commingled with oil of differing quality from other leases.

While the MMS has made great strides in this Notice in proposing a reasonable valuation method, BP still has a number of concerns about the practical application and validity of the proposed method. Our specific concerns are as follows:

- The Section-by-Section Analysis of 206.102(c) states that if an overall balance agreement is found to exist in an exchange agreement, the royalty payer would be required to value its production under 206.103 or the total consideration received, whichever is greater. BP strongly disagrees with the MMS's proposal to use a "higher-of" rule in any circumstance. The use of a "higher-of" approach would allow the MMS to take advantage of any systemic differences between the methods and receive the higher value, which over time would result in the MMS receiving greater than the value of the oil. In our October 21, 1997, comments, BP offered an extensive discussion of the inherent bias against the producer in any method that has a "higher-of" approach.
- Of major concern to BP is the provision in 206.102(c)(3) which requires the royalty payer to value oil sold in an arm's-length exchange agreement at the gross proceeds received for the return crude oil adjusted for any location or quality differential received or paid. BP agrees that the value

of royalty oil sold through exchanges should be the value of the return crude oil plus or minus the differential. While the valuation method is reasonable, the practical implementation of this method would likely be impossible. Most exchanges done by BP typically involve the receipt by BP of WTI in exchange for the delivery by BP of leasehold oil. Identification and isolation of the WTI received in these exchanges from WTI received and sold in hundreds of other transactions done by BP in any delivery month would be extremely difficult if not impossible. Without the ability to isolate and identify WTI related to the transactions involving federal leasehold oil, BP would not know which of the millions of WTI barrels sold by BP in a given delivery month to apply to the valuation of the royalty oil.

BP recommends that the MMS consider an alternative to its proposed method that requires a royalty payer to trace the return barrels to their final sales disposition. We would propose that the value of royalty oil sold through an arm's-length exchange be calculated based on the spot market value, as quoted in a MMS-approved publication, of the receipt crude oil adjusted for any location or quality differential received or paid. This method eliminates the need for barrel tracing, and provides the MMS with a verifiable valuation method. This proposed method has been used extensively by the State of Alaska in its valuation of oil for production tax purposes.

- 206.102(d)(1) requires the royalty payer to demonstrate that a contract or exchange agreement is an arm's-length contract or exchange agreement, and 206.110(a) requires the royalty payer to demonstrate that a transportation contract is an arm's-length agreement. BP believes these requirements are overly burdensome and unnecessary and that the requirement for a company to certify that the arm's-length contract provisions include all of the consideration related to the deal should provide adequate assurance. This certification should provide the basis on which the MMS establishes the validity of the arm's-length nature of a contract.
- 206.103(b)(4) allows producers of oil in the Rocky Mountain Area the right to request an alternative valuation method if the proposed methods do not result in a reasonable value for their production. BP believes this right should be extended to all areas of the country since the index pricing method can result in values not representative of the value of the oil in non-Rocky Mountain Areas.

- Section 206.113 identifies the adjustments and transportation allowances that may be used when index pricing is used. These allowances do not always result in a reasonable reflection of the value of oil at the lease. Areas of specific concern are the following:
  - 206.113(a) allows pipeline quality bank adjustments for non arms-length exchange agreements, but does not provide any adjustment for quality differences between the index price and the royalty oil in the absence of a pipeline quality bank.
  - 206.113(b) states that for lease production moved directly to an alternative disposal point, the only adjustments allowed are for actual transportation costs between the aggregation point and the lease and pipeline quality bank adjustments. These limited adjustments do not adjust for quality differences between the index price and the royalty oil at the aggregation point.
  - 206.113(c) states that for oil moved directly to a MMS-identified market center, the only adjustments allowed are for actual transportation costs between the market center and the lease and pipeline quality bank adjustments. These limited adjustments do not adjust for quality differences between the index price and the royalty oil at the aggregation point.
- BP continues to be dismayed by the MMS's disallowance of numerous reasonable and actual costs incurred to transport oil. In particular, we disagree with the disallowance of midstream transportation costs for activities which add value to oil produced at the lease. These include costs related to personnel and activities involved in the transportation of oil from the lease to the aggregation point or market center. Examples of the activities involved include pipeline scheduling, pipeline inventory management, environmental and safety assurance, and sample gathering. These are necessary transportation functions, and their associated costs should be included in the transportation allowance. Additionally, the MMS's disallowance of costs related to actual and theoretical losses is a disallowance of real costs incurred by the producer to move oil off the lease.
- Based on the currently proposed valuation rules, BP would not have a need for the data collected on Form 4415. We suggest that the MMS do a survey of the industry to determine in what circumstances Form 4415 data

is necessary. If the needs are small, we suggest that the MMS propose an alternative valuation method for the affected barrels, thus relieving the industry of a significant administrative burden.

In addition to the concerns listed above, there are a number of areas in the proposed rules that BP believes are unclear. Each of these is summarized below:

- 206.102(b) states that for oil valued under the gross proceeds method and sold under multiple arm's-length contracts, the value of the oil is the volume weighted average of the values established for each of the contracts. It is unclear whether a similar method would be used if some of the oil is valued under the gross proceeds method and some of the oil is valued under the index pricing method.
- 206.103(c) states that index pricing for leases not located in California, Alaska, or the Rocky Mountain Area is based on the spot prices of crude oil in the market center nearest to your lease and for oil most similar in quality. It is unclear how the choice of the base crude should be determined. A producer may need to choose a base crude further from the lease or of less similar quality if that crude is a "currency crude" such as WTI at Cushing for which there is sufficient Form 4415 exchange date or arm's-length exchange data to allow for a market related quality and location differential.
- 206.111(b)(1) and (2) reference paragraphs (b)(4)(i) and (ii). This reference appears to be incorrect. We assume the MMS meant to reference paragraphs (c)(4)(i) and (ii).

The comments above apply to oil produced from federal leases in all parts of the country. BP is not a participant in the Rocky Mountain Area, and therefore does not feel it is appropriate to comment on the proposed rules specific to those leases. BP, however, is an active participant in the production of Alaskan North Slope (ANS) oil from federal leases. Like the Rocky Mountain Area, Alaska is a remote location with unique marketing characteristics, including the sale of the oil in widely diverse locations such as the West Coast, Alaska, Mid-Continent and Far East. In addition, Alaska poses unique transportation logistics involving pipeline and marine movements over thousands of miles. Due to these characteristics, BP believes the MMS should provide a valuation method for ANS which addresses its unique transportation and marketing characteristics. The current valuation

method proposed by the MMS does not address the complexity of the ANS markets and transportation systems. Specific problems that we have identified include the following:

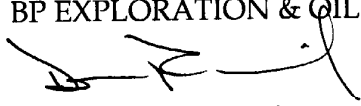
- Long transit times result in customer sales occurring many weeks or months after production in numerous, diverse markets. The proposed rules do not discuss how to trace barrels back to the lease given the complexity of this system.
- Index price valuation is based exclusively on West Coast ANS prices and transportation costs. This ignores the significant volume of ANS shipped by BP to other markets. These markets typically have lower prices and higher transportation costs than the West Coast market. Valuation by the MMS on a West Coast basis would overvalue a significant portion of ANS produced by BP.
- The use of spot quotes in the index price method which match the lease production month and the spot delivery month ignores the logistic reality of the ANS market. Transit and inventory holding times for ANS often result in deliveries to customers occurring many months after production.

BP proposes that the MMS discuss the need for Alaska specific rules with the industry. In a manner similar to the Rocky Mountain Area, MMS needs to provide a valuation method that is appropriate for Alaska's unique transportation and marketing characteristics.

BP's comments to the Notice are intended to be constructive and helpful to the MMS in developing a final rule that strikes an equitable balance among the interests of all parties, and we trust that this will be the spirit in which our comments are received and considered by the MMS. BP representatives are available to clarify or provide further elaboration with regard to any of our comments should the MMS so desire.

Respectfully submitted,

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